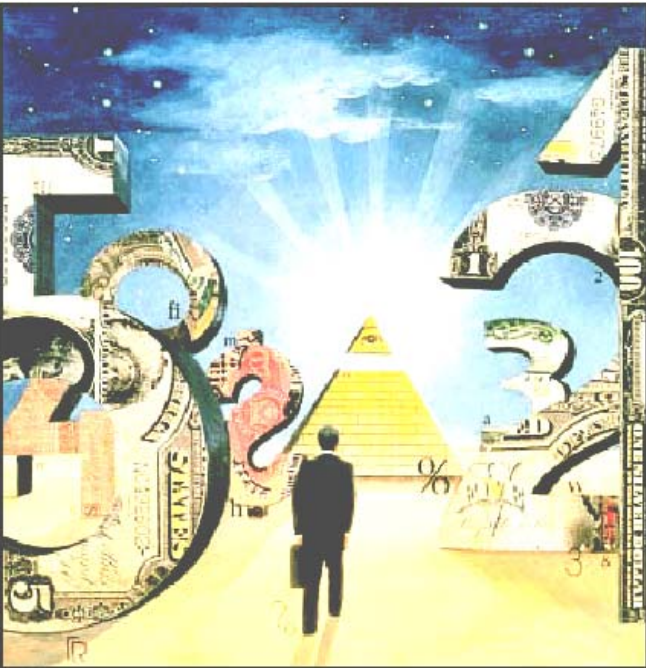


MERCER

Human Resource Consulting



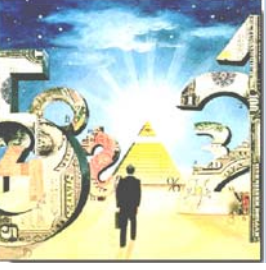
April 15, 2005

Arizona State Retirement System Fiduciary Update

Douglas R. McClintock, JD

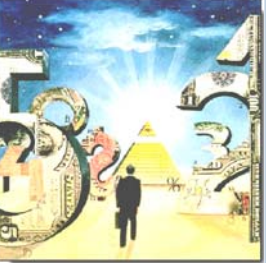


Marsh & McLennan Companies



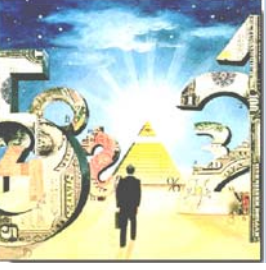
ASRS Board Member Responsibility

- Act as a trustee
- Comply with broad fiduciary standards
- Oversee administration of benefits and investment of assets
- Report activities and performance
- Perform any other duties expressly assigned under statutes



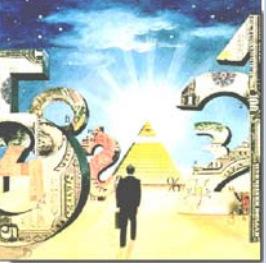
Who Are the Fiduciaries at ASRS?

- All Board members as trustees
- The legislature is obligated to fund the system, but their duty is primarily contractual
- Internal staff who have discretion and control over the administration of benefits or oversight of the assets
- Investment Managers and Investments Consultants
- Generally, attorneys, auditors and actuaries act in non-fiduciary roles



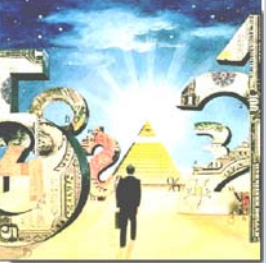
Guidance for Fiduciaries

- The common law of trusts
- The Employee Retirement Income Security Act of 1974 (ERISA)
- Federal, State and City statutes
- Court decisions
- Advice of legal counsel
- Attorney General opinions



Principal Fiduciary Duties

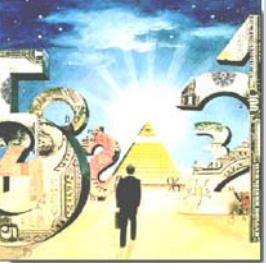
- The duty of prudence
- The duty of loyalty
- The duty of care
- Many other specific duties that stem from these two cover a wide range of topics
- A person's fiduciary duty is limited to the scope of responsibility they are assigned or they assume



Duty of Prudence

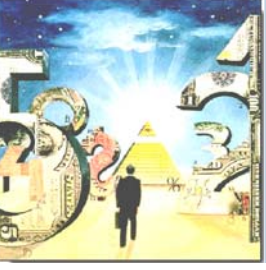
Prudent Investor Standard

- Evolved from the “Prudent Man” standard which focused primarily on capital preservation
- Requires reasonable care, skill and caution
- Decisions evaluated in the context of the total portfolio
- Reasonable effort to verify facts
- No investment is per se imprudent
- Requires appropriate diversification to achieve a reasonable return with an acceptable level of risk
- Duty to use special skills or expertise and delegate responsibility where appropriate



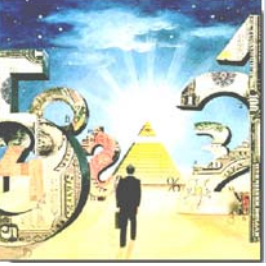
Prudent Expert Standard

- Trustees will be judged by the care, skill, prudence and diligence under the circumstances then prevailing that a prudent (expert) (person) acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.
- This establishes the conduct of other experts as the benchmark for evaluating a fiduciary's actions
- Even more stringent than the Prudent Investor standard
- Requires fiduciaries to know when they have sufficient experience and knowledge and when they need to delegate responsibility or seek expert advice



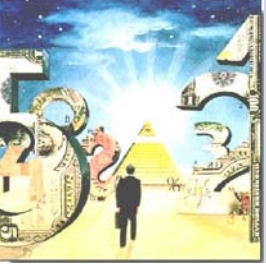
Exercising Prudence

- Trustees must use and share all the skills they have from their education and prior experience
- If trustees are not experts:
 - they must carefully hire, monitor, and evaluate the experts they rely on
 - must continuously improve their level of knowledge
- Experts must actually have the necessary expertise
- Questioning experts is prudent
- Second opinions might be necessary at times
- Trustees have the ultimate responsibility



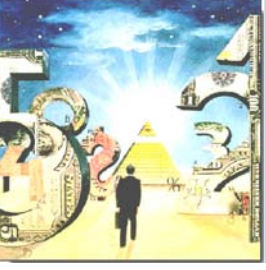
Prudence Requires Strict Financial Guidelines

- Trustees must incur only “reasonable” expenses
- It is not always easy to define “reasonable” for:
 - Technology
 - Investment management
 - Investment advice
 - Legal advice
 - Staff salaries
 - Custodial bank services
- Spending too little can cause more problems than spending too much



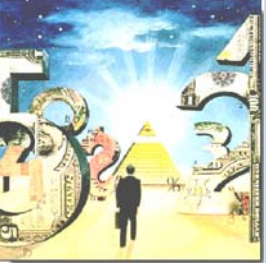
Interpretation of Prudence

- Use current standards, not outdated ones
- Consider what is going on nationally
- Focus on public sector and ERISA retirement trusts
- Follow best practices
- A good (prudent) process is more important than a good outcome



Practical Advice

- To ensure you are meeting the duty of prudence
 - Invite and listen to concerns of staff and advisors
 - Ask about legal and policy compliance and exceptions
 - Monitor those to whom you have delegated duties
 - Know who is accountable for what
 - Study financial audit findings and address issues promptly
 - Seek out the best practices of others
 - Seek independent opinions (e.g., independent, financial and actuarial audits)



Fiduciary Latitude

Public Funds

Prudent Expert/Public Scrutiny

Corporate/Union Pension Funds

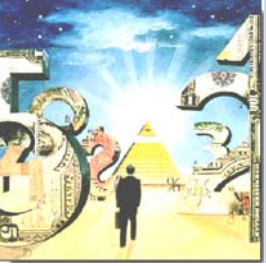
ERISA Prudent Expert

Not-for-Profit Boards

Prudent Person

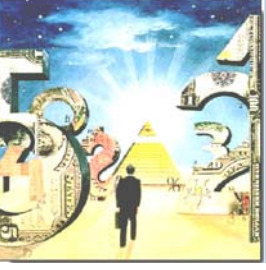
Corporate Board of Directors

Business Judgment Rule



Duty of Loyalty

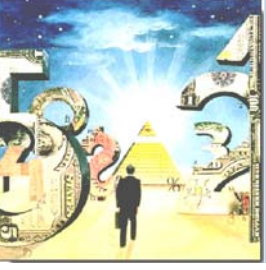
- Applies to all responsibilities of the Board and fiduciary staff
- Greater duty than in any other legal relationship
- Fiduciaries also must act in the best interest of the member or beneficiary
- This duty requires strict adherence to the purpose of the trust
 - Pay benefits
 - Ensure that sufficient funds are available to pay benefits
- Funds cannot be diverted for any other purpose
- Provides the press with easy targets when this duty is breached



Duty of Loyalty

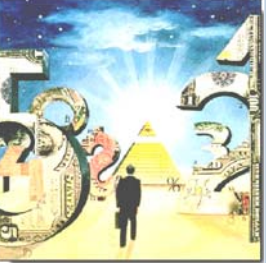
- Fiduciaries are to act solely for the benefit of the beneficiaries of a trust
- This is called the “exclusive benefit rule”
- There is to be no consideration for secondary interests
 - Economically targeted investments
 - Socially laudable initiatives
 - Charitable gifts
- Trustees have “an unwavering duty of complete loyalty” to the members and beneficiaries of an employee benefit plan.
- The “duty to the trust beneficiaries must overcome any loyalty to the interest of the party that appointed the [trustee].”

U.S. Supreme Court



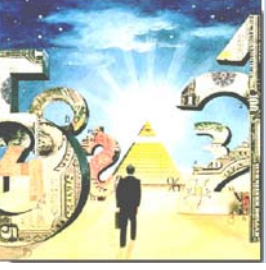
Loyalty to Whom?

- What duty or obligation is owed to:
 - Taxpayers
 - Appointing and electing authorities
 - “Constituents”
 - Local business community
- People expect you to represent them and be their advocates
- They may want their needs taken into account:
 - Economic development
 - Political favors
 - Budget deficits
- Most do not understand that a fiduciary’s duty is very specific



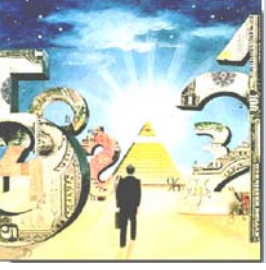
Duty of Loyalty

- Trustees are to avoid:
 - Conflicts of interest
 - Self-dealing
 - Self-enrichment
 - The appearance of impropriety
- Courts are very strict on fiduciaries
- The “court of public opinion” is very strict as well
- The standards are higher than ever
- Detailed prohibited transaction rules require transactions be transparent and at arm’s length



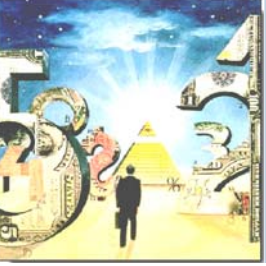
Duty of Loyalty

- Be aware of:
 - Doing favors for friends
 - Advocating exceptions to policies
 - Bending the rules
 - Ignoring the statutes
 - Acting as though you run a charitable organization with wide latitude on how to spend money



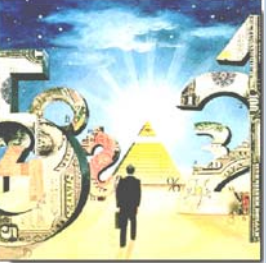
Conflicts of Interest

- Do not act in ways that benefit you personally as a member or retiree of the fund
- Do not act in ways that benefit you personally as an employer whose staff is covered by the fund
- Exception – if the entire group benefits and you are part of the group, this is okay
- Exception – if you are merely obeying the law



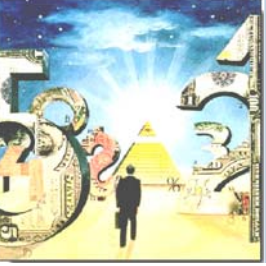
Duty of Loyalty Case Law Examples

- Duty of West Virginia Retirement System trustees to demand adequate resources and funding for system (Dadisman v. Moore, 1988)
- Duty to pay benefits to right person (Weaver v. New York City Employees' Retirement System, 1989)
- CalPERS pension raid (Claypool vs. Wilson, 1992)



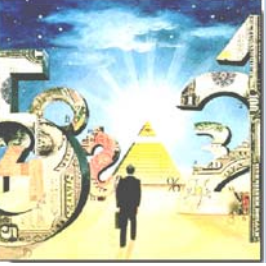
Duty of Care

- General duty to adopt and follow policies and procedures designed to correctly administer the system
- Need to maintain and protect adequate records
- Must maintain confidentiality of data, where appropriate
- Requires regular audits
- Any legal matters affecting the plan must be appropriately prosecuted or defended



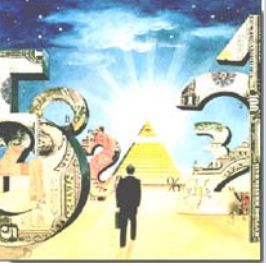
Basic Fiduciary Duties

- Selecting agents
- Overseeing staff and agents
- Conveying information to members and beneficiaries
- Paying benefits
- Collecting contributions
- Correcting errors
- Handling hearings or appeals



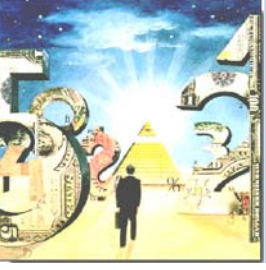
Basic Fiduciary Duties

- Setting asset allocation and diversifying the portfolio
- Seeking investment advice, if needed
- Documenting transactions and processes
- Incurring only reasonable expenses
- Keeping abreast of best practices



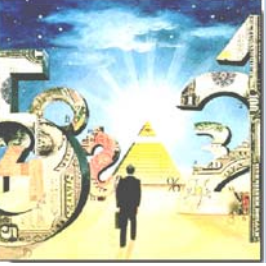
Fiduciary Responsibility May Be Delegated

- Virtually all fiduciary responsibilities can be delegated
- Delegation must be clear and pursuant to a prudent process
- Delegation must be accompanied by diligent oversight
- Typical delegated duties
 - Investment portfolio monitoring
 - Due diligence activities
- Typical non-delegated duties
 - Executive Director and Chief Investment Officer selection and evaluation
 - Asset allocation
 - Strategic planning



Prudent Delegation

- Boards delegate substantial responsibility to Executive Directors and Chief Investment Officers
- Generally, delegations should be made in writing
- The Executive Director's and Chief Investment Officer's job descriptions are important
- Written performance criteria and annual evaluations are also important
- Clear written policies also support prudent delegation



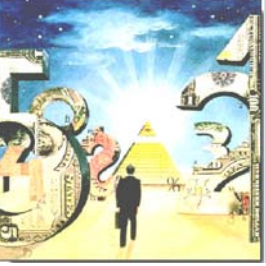
Public vs. Private Sector

Public

- Fiduciaries only act in a fiduciary capacity
- Public scrutiny
- Must work with the legislature
- Subject to state statutes, Attorney General opinions
- Fully discretionary trustee

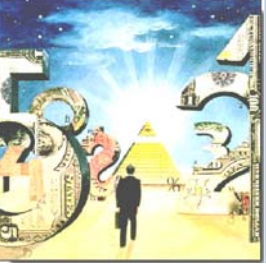
Private

- Fiduciaries act in fiduciary and non-fiduciary capacity
- Limited visibility
- Self governing
- Subject to ERISA and Internal Revenue Code
- Typically, directed trustee



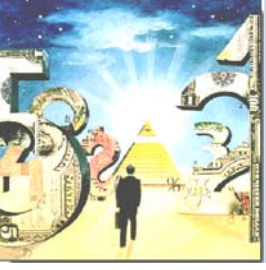
Potential Circumstances with Fiduciary Implications

- Legislative enactment jeopardizes funding of the trust
- Trustees have fiduciary obligation to provide for payment of benefits
- Trustees should seek legal opinion for guidance
- Reliance upon independent legal advice is evidence of prudence
- Trustees may be required to initiate legal action
- Must balance the costs of litigation with the likelihood of prevailing



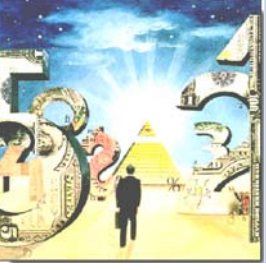
Case Studies

- What are the fiduciary issues presented?



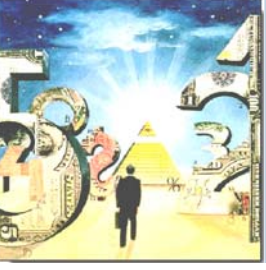
Fiduciary Liability

- Fiduciary liability = personal liability
- Financial and reputational consequences
- Long-term effects on the organization



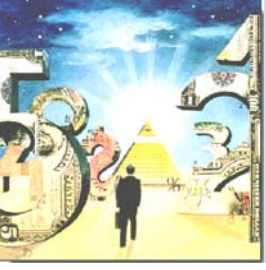
Avoidance of Liability

- Orientation and continuing fiduciary education
- Thorough decision-making processes
- Clear documentation of Board actions
- Reliance on expert advice
- Legal review prior to making investments
- Fiduciary liability insurance
- Good governance and ongoing oversight activities
 - Know the risks
 - Understand the expectations
 - Have and adhere to careful, thorough, scrupulous policies
 - Judge oneself before others do



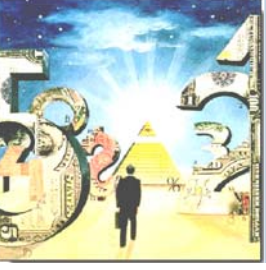
Co-fiduciary Liability

- Co-fiduciary liability means “you are your brother’s keeper”
- If you know of a violation by another fiduciary and you do nothing about it, you are breaching your fiduciary duty
- You have a duty to prevent the breach or to remedy another fiduciary’s breach
- Remember this as the “duty to squeal”
- Fiduciaries are not relieved of responsibility by their lack of involvement – failure to monitor conduct of other trustees can be a breach of fiduciary duty



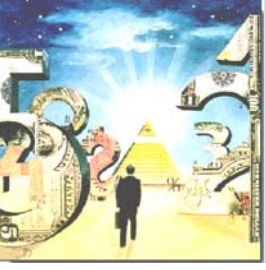
Practical Advice

- Have an annual “booster shot” on fiduciary responsibility
- Have ethics and conflicts of interest policies in place to guide you and be trained on what they mean
- Set up ways to monitor and evaluate yourselves as trustees
- Recognize that the staff may find it difficult to point out your fiduciary breaches



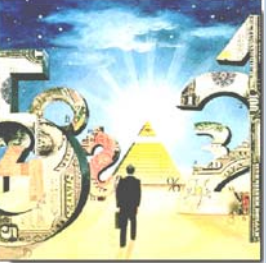
Current Industry Topics

- Lower funded status of defined benefit plans
 - poor market returns in recent years
 - Actuarial smoothing prolonging the effects
 - Reduction in contribution rates granted during the “good years”
 - Benefit improvements in the 1990’s
 - Baby boomers retiring
- Fiscal crisis in state and local governments
 - Lower general bond ratings
 - Pension obligation bonds
 - Diversion of contributions



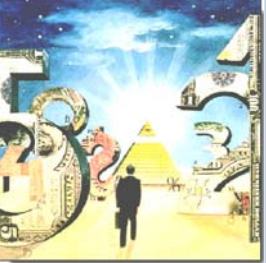
Current Industry Topics

- Social Security
 - Offsets with public pensions
 - Mandatory coverage for all public employees
 - Structural adjustments
- Retiree healthcare
 - Availability of coverage
 - Costs and medical inflation
 - Retiree medical benefits account
- Attention to Board governance



Current Industry Topics

- Controversies in retirement plans
 - San Diego City Manager resigns
 - Indiana payments to convicts
 - Houston final pay manipulation
 - Louisiana's gifts and entertainment
- Mutual fund scandals
 - Late trading practices
 - Frequent trading practices
 - Insider trading
 - Disclosure of managers' pay
- Investment consultants' conflicts
 - SEC inquiry



Questions

